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BEFORE THE ARIZONA CORPORATION COMMISSION

DOCKETED

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WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

DOCKETED BY

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IN THE MATTER OF THE APPLICATION OF
MIDVALE TELEPHONE EXCHANGE, INC. FOR
AUTHORITY TO INCREASE RATES AND FOR
DISBURSEMENT FROM THE ARIZONA
UNIVERSAL SERVICE FUND

DOCKET NO. T-02532A-00-0512

DECISION NO. 64011**OPINION AND ORDER**

DATE OF HEARING: May 21, 2001

PLACE OF HEARING: Phoenix, Arizona

PRESIDING JUDGE: Mr. Stephen Gibelli and Mr. Dwight Nodes¹

APPEARANCES: Mr. Conley Ward, GIVENS PURSLEY, L.L.P. and Ms. Tamara Herrera, RYLEY, CARLOCK & APPLEWHITE, on behalf of Midvale Telephone Exchange, Inc.;

Mr. Todd C. Wiley, GALLAGHER & KENNEDY, on behalf of Citizens Communications Companies;

Ms. Theresa Dwyer, FENNEMORE CRAIG, on behalf of Qwest Corporation; and

Ms. Maureen A. Scott, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On July 17, 2000, Midvale Telephone Exchange, Inc. ("Company" or "Midvale") filed with the Arizona Corporation Commission ("Commission") an application for authority to increase rates and for disbursement from the Arizona Universal Service Fund ("AUSF"). On August 2, 2000 Qwest Corporation ("Qwest") filed a Motion to Intervene. On August 11, 2000, the Commission's Utilities Division Staff ("Staff") filed a letter indicating the Company's rate application was sufficient and classifying the Company as a Class A utility. On August 15, 2000, by Procedural Order, Qwest was granted intervention. On August 28, 2000, a Procedural Order was issued setting the matter for

¹ Mr. Stephen Gibelli presided over the pre-hearing conference and Mr. Dwight Nodes presided over the hearing. This Opinion and Order was prepared by Mr. Stephen Gibelli.

1 hearing on April 19, 2001. On January 24, 2001, Citizens Communications Companies ("Citizens")
2 filed Motion to Intervene. On January 25, 2001, Staff and Midvale filed a Motion to Extend the
3 Procedural Schedule due to Discovery Issues. By Procedural Order issued on February 1, 2001, the
4 hearing was continued until May 21, 2001. On May 8, 2001, Citizens was granted intervention by
5 Procedural Order.

6 The matter came before a duly authorized Administrative Law Judge of the Commission at
7 the Commission's offices in Phoenix, Arizona on May 21, 2001. Midvale, Qwest, Citizens, and Staff
8 appeared through counsel. At the conclusion of the hearing, the matter was adjourned pending
9 submission of simultaneous initial and reply briefs on July 2, and July 13, 2001, respectively.

10 DISCUSSION

11 I. NATURE OF CASE

12 Midvale is an Idaho corporation authorized to do business in Arizona since 1989. Midvale
13 provides service to approximately 2,000 subscribers in ten rural exchanges in Idaho, Oregon, and
14 Arizona.

15 In its application, Midvale is seeking an increase in rates for its current customers. Midvale's
16 existing rates were established in Decision No. 58736 (September 1, 1994). Midvale's application is
17 based on a test year ("TY") ending December 31, 1999.

18 Midvale seeks an extension of its Certificate of Convenience and Necessity ("Certificate") to
19 provide service to the Millsite and Silver Bell exchanges. Midvale also proposes that it receive
20 AUSF funds and be allowed to offer extended area service ("EAS") from Midvale's Cascabel
21 exchange to Qwest's Benson and San Miguel exchanges.

22 II. EXTENSION OF CC&N

23 As part of its application, Midvale is proposing to establish service in two separate areas that
24 currently lack any wireline service. The Millsite exchange will include four contiguous subdivisions
25 located about 15 miles south of Prescott, plus the Henderson Valley Ranch subdivision located north
26 of the Millsite area, about 15 miles east of Prescott. The Silver Bell exchange will serve an area
27 about 50 miles southwest of Phoenix including the Silver Bell, Sawtooth, and Rio Verde
28 subdivisions. Over the next three years, Midvale expects the Millsite exchange to serve about 200.

1 customers and the Silver Bell exchange to serve about 185 customers.

2 Staff is in support of the extension of Midvale's Certificate into the Millsite and Silver Bell
3 exchanges.

4 Many customers in the proposed extension areas filed letters or provided public comment in
5 support of Midvale's proposal to serve the Millsite and Silver Bell exchanges. Currently no
6 telecommunications company is serving the areas. No telecommunications company has shown as
7 much interest in serving the areas as much as Midvale has. The residents in the area have been
8 without local telephone service and Midvale is a suitable entity to serve the area. Midvale's proposal
9 to extend its Certificate to serve the Millsite and Silver Bell exchanges is reasonable and in the public
10 interest and should be approved.

11 III. EXTENDED AREA SERVICE

12 As part of its application, Midvale requests authorization to offer EAS between the Cascabel
13 exchange and the towns of Benson and San Manuel. EAS is a service offered in a geographic area
14 beyond the local service area to which traffic is classified as local for selected customers. It allows
15 subscribers in one exchange to call subscribers in another exchange without a toll charge.

16 Although the Commission has no rule or regulation on the issue of when EAS is appropriate,
17 in Decision No. 58927 (January 3, 1995), the Commission discussed a process to determine if there is
18 a "community of interest" in EAS. In that case, Staff recommended that the Commission "consider
19 calling volumes, socio-economic linkages, contiguity and public input as factors in determining
20 whether a community of interest exists." (Id.) Staff also suggested in that docket that a community
21 of interest may be present if at least 10 percent of the customers in the exchange or 200 customers,
22 whichever is less, have submitted a petition to the Commission. The purpose behind those
23 recommendations was to determine whether or not consumers want the service. Once that was
24 determined, then cost and rate design issues were considered.

25 In this case, Midvale has not submitted a petition on behalf of residents in the Cascabel
26 exchange indicating an interest in EAS. In support of its application, Midvale states that the towns of
27 Benson and San Manuel have a "strong community of interest" with Cascabel and that its studies
28

1 show that there is sufficient voice traffic to support extending the local calling area.² However,
2 Qwest's studies demonstrate that fewer than two percent of its customers in the Benson and San
3 Manuel exchanges called Cascabel in the months studied. (Rook Direct pg. 7). In addition, only 20
4 percent of Midvale's customers make a majority of the calls from Cascabel to Benson and San
5 Manuel. (Buckalew Direct pg. 19).³

6 Staff recommends that Midvale's request to offer EAS should be denied. Staff points out that
7 Midvale has not provided any socio-economic studies that would demonstrate that there is a
8 "community of interest" between the exchanges for which EAS is proposed. In addition, Staff also
9 notes that all consumers in Arizona would be paying for the service. Staff believes that to ask all
10 Arizona consumers to finance these two EAS routes when only 20% of Midvale's customers make
11 the majority of calls, is unreasonable.

12 As part of its application, Midvale is seeking AUSF funding, in the amount of \$40 a month
13 per customer, to fund its EAS proposal. This AUSF funding is paid for by all Arizona consumers
14 who would, in essence, be subsidizing the EAS service. Staff believes that when considering the
15 small percentage of customers who would benefit by EAS, it is not justifiable for all Arizona
16 customers to subsidize the service when it is not necessary and there are reasonable alternatives such
17 as less expensive toll plans.⁴

18 Citizens and Qwest both contended that Midvale's EAS proposal does not fully consider the
19 potential for EAS fraud or bridging. EAS bridging is a form of illegal arbitrage whereby a company
20 uses a combination of a line, call forwarding services, and possibly its own equipment to complete
21 calls between two or more overlapping EAS areas in order to avoid paying toll or access charges.
22 Midvale's proposal would result in local calling between San Manuel and Cascabel and Cascabel and
23 Benson since the local calling areas of Benson and San Manuel will overlap into Cascabel. An EAS
24 bridger could subscribe to local flat rated access lines in Cascabel and use call forwarding services to

25 ² Midvale stated that Cascabel customers make 8.5 calls per line per month to Benson and 2.5 calls per line per month to
26 San Manuel (Reading Direct pg. 22, see Exhibit 6, schedule 1).

27 ³ Qwest has concluded that less than 2% of its customers in San Manuel and Benson called Cascabel. (Rook Direct pg.
7).

28 ⁴ Staff has pointed out that Cascabel customers already have less costly alternatives to call Benson and San Manuel.
Cascabel, Benson, and San Manuel are all in the same LATA, and Qwest offers 10 cents per minute, 24 hours, 7 days a
week for residential customers. (Buckalew Direct pg. 20).

1 forward calls between Benson and San Manuel, allowing customers in those exchanges to avoid toll
2 charges.

3 Other states have spent a great amount of effort to shut down illegal EAS bridging and
4 Midvale's EAS proposal invites EAS bridging in Arizona. There was no evidence presented to show
5 that such bridging is currently happening in Arizona. However, illegal bridging is a legitimate
6 concern and will require a great effort to shut down once it has begun in Arizona.

7 Midvale has failed to demonstrate that its EAS proposal is necessary and reasonable at this
8 time. Midvale has failed to provide sufficient evidence demonstrating that there is "strong
9 community of interest" in support of EAS. Weighing this fact, the additional costs to Arizona
10 consumers, and the added threat of EAS bridging against the small number of customers who would
11 benefit, we find that Midvale's proposal is not reasonable or appropriate at this time. However, we
12 agree with Qwest and Citizens that there are no rules in Arizona governing the review of EAS
13 proposals. Other jurisdictions have established such rulemaking dockets for the purpose of
14 developing standards for EAS proposals. We shall therefore open up a rulemaking docket to clarify
15 the Commission's EAS requirements. This rulemaking docket should address, at a minimum, such
16 issues as (1) how "community of interest" should be defined; (2) the significance of call volumes; (3)
17 whether a customer petition should accompany a proposal; (4) how companies can recover the cost of
18 EAS; and (5) how the potential for illegal EAS bridging should be evaluated.

19 IV. RATE BASE

20 In its application, the Company proposed an intrastate original cost rate base ("intrastate
21 OCRB") of \$1,807,096. Staff proposed adjustments which resulted in an intrastate OCRB of
22 \$1,244,841. Staff made five adjustments to the rate base proposed by the Company, prior to
23 separation for intrastate items.

24 A. Plant in Service

25 The Company proposed a Plant in Service balance of \$4,135,313, including both intrastate
26 and interstate plant, compared to Staff's proposed balance of \$3,042,091. Staff's proposed intrastate
27 Plant in Service balance is \$1,945,021.

28 Staff made five adjustments reducing the plant balances proposed by the Company. Staff

1 removed four Pro Forma additions related to unserved areas proposed by the Company. The
2 proposed additions were for land, plant, and equipment to serve the unserved areas. In total, Staff
3 removed \$1,087,603 in plant additions for the unserved areas. Staff states that it consistently does
4 not allow Pro Forma plant in OCRB since it is not "used and useful" nor "known and measurable."

5 Staff also reduced the Public Telephone Equipment account for the Young exchange by
6 \$5,619 as a result of an April 1997 decision by the Federal Communications Commission
7 deregulating pay telephones. Midvale has agreed to Staff's adjustments pertaining to Public
8 Telephone Equipment. We concur.

9 Staff's adjustments resulted in a total decrease of \$1,093,222 from the Company's proposed
10 plant in service balance, resulting in a recommended amount of \$3,042,091. After separation of the
11 intrastate and interstate plant, Staff recommends an original cost plant in service of \$1,945,021.

12 It is a fundamental rate making concept that revenues and expenses must be "known and
13 measurable" before they are recognized in a ratemaking context. The pro forma adjustments
14 proposed by Midvale are not "known and measurable." The plant has not yet been built. The costs
15 are based solely on estimates and to include them in rate base would violate traditional ratemaking
16 concepts. Therefore, we adopt Staff's adjustments to disallow Midvale's pro forma adjustments to
17 plant in service.

18 B. Accumulated Depreciation

19 Midvale's application reflects an Average Accumulated Depreciation of \$1,167,196 for the
20 TY ending December 31, 1999, which includes \$373,775 for the Cascabel exchange and \$793,421
21 for the Young exchange. Staff recommends a decrease in Accumulated Depreciation of \$224,220,
22 resulting in Staff's proposal of \$942,976 which includes Staff's recommended intrastate
23 Accumulated Depreciation balance of \$600,581.

24 For the Cascabel exchange, Staff reduced the amount of Accumulated Depreciation by
25 \$9,195. Staff's adjustment was based on the depreciation expense for each year since inception in
26 August of 1993 through the end of the test year. Staff took the proposed Accumulated Depreciation
27 at December 31, 1999 of \$404,849 and averaged the balance with the Accumulated Depreciation
28 balance as of December 31, 1998 (\$324,311). Staff recommends an Average Accumulated

1 Depreciation balance of \$364,580 for the Cascabel exchange.

2 For the Young exchange, Staff reduced the Company's proposed Accumulated Depreciation
3 by \$215,025, from \$793,421 to \$578,396. Staff calculated the Accumulated Depreciation at
4 \$514,326 and then averaged the December 31, 1999 balance with the Accumulated Depreciation
5 balance as of December 31, 1998 to arrive at an Average Accumulated Depreciation of \$578,396.

6 Altogether, Staff recommends a decrease in Accumulated Depreciation of \$224,220 from the
7 Company proposed amount of \$1,167,196, resulting in Staff's calculated amount of \$942,976. After
8 applying in the intrastate factor of 63.69 percent, Staff recommends an intrastate Accumulated
9 Depreciation balance of \$600,581.

10 In its Rebuttal testimony, the Company accepted Staff's adjustments to the Accumulated
11 Depreciation balances (Reading Rebuttal pg. 7).

12 Staff's adjustments to Accumulated Depreciation and corresponding changes to Average
13 Accumulated Depreciation and the calculation of the intrastate Accumulated Depreciation are
14 reasonable. We therefore adopt Staff's adjustments to Accumulated Depreciation.

15 C. Rate base summary

16 Intrastate Rate base (per Midvale)	\$1,807,096
17 Intrastate Commission-approved adjustments	(\$562,255)
18 Intrastate Rate Base (per Commission)	\$1,244,841

19 Midvale did not file any reconstruction cost new rate base amounts. Therefore, we find the
20 above-described OCRB to be the adjusted Fair Value Rate Base ("FVRB") for the TY.

21 **V. OPERATING INCOME**

22 In its application, Midvale indicates that its total company TY operating revenues were
23 \$1,258,613 prior to intrastate separation. Staff's adjustments resulted in a recommended decrease of
24 \$170,988 for a Staff recommended operating revenue of \$1,087,625. After adjustments for interstate
25 revenues, Staff's recommended TY intrastate operating revenues are \$730,428.

26 A. Local Service Revenues

27 Midvale proposes a TY amount of \$172,369 for local service revenues and a pro forma
28 adjustment to increase the amount by \$81,599 to reflect Midvale's estimated revenues from serving

1 the unserved areas, resulting in total adjusted local service revenues of \$253,968.

2 Staff believes that the inclusion of the estimated revenues of \$81,599 from the unserved areas
3 is not appropriate because the estimated revenues are not "known and measurable."

4 We concur and adopt Staff's recommendation of \$172,369 for local service revenues.

5 B. Network Access Service Revenues

6 In its application, Midvale included TY total company network access service revenues of
7 \$563,821. Midvale proposes a pro forma adjustment of \$17,190 to reflect its removal of access
8 revenue associated with its EAS request. Midvale is also seeking a pro forma adjustment to increase
9 this amount by \$120,908 as a result of estimated revenues expected from the unserved areas.
10 Midvale's total network access revenues prior to intrastate adjustments amount to \$667,539.

11 Staff rejected both of Midvale's proposed pro forma adjustments. Based upon its rejection of
12 Midvale's EAS proposal, Staff also rejected the \$17,190 revenue adjustment. Staff also rejects
13 Midvale's pro forma adjustment to increase revenues based on estimated revenues from the unserved
14 areas because they are not "known and measurable."

15 Since we are not adopting Midvale's EAS proposal, Midvale's proposed \$17,190 adjustment
16 should also not be adopted. In addition, Midvale's proposal to increase revenues based on estimates
17 from unserved areas is not appropriate because the revenues are not "known and measurable."
18 Therefore, we adopt Staff's recommended amount of \$563,821 for network access service revenues
19 prior to intrastate adjustments. After intrastate adjustments, Midvale's network access service
20 revenues are \$206,624.

21 C. Interstate Universal Service Fund Revenues

22 In its application, Midvale included \$107,050 of TY universal service fund revenues.
23 Midvale proposes a pro forma adjustment to increase this amount by \$221,824 for the total company
24 as a result of increased funding due to the lifting of federal caps on universal service funds. Midvale
25 also proposes a pro forma adjustment to decrease these revenues by \$15,687 as a result of loss of
26 funding due to its EAS request. Midvale's total proposed universal service fund revenues are
27 \$313,187.

28 Staff agrees with Midvale's adjustment as a result of the lifting of universal service fund caps,

but disagrees with Midvale's pro forma decrease of \$15,687 for the loss of funding due to the EAS request.

Staff's adjustments are reasonable and should be adopted. Consistent with our determination on Midvale's EAS proposal, it is not appropriate to grant Midvale's pro forma adjustment for its loss of universal service funding. As a result, we adopt Staff's figure of \$328,874 for universal service fund revenues.

D. Miscellaneous Revenues

In its application, Midvale includes \$22,081 as its TY miscellaneous revenues. Midvale made a pro forma adjustment increasing these revenues by \$2,073 to include estimated revenues expected from the unserved areas.

Staff recommends decreasing intrastate miscellaneous revenues by \$2,073 since these estimated revenues are not "known and measurable."

We agree that estimated revenues are not "known and measurable" and therefore adopt \$22,081 for Midvale's miscellaneous revenues.

E. Uncorrectable Revenues

In its application, Midvale proposes TY uncorrectable revenue of \$1,279 and made a pro forma adjustment increase of \$715 to include estimated uncorrectable revenue from the unserved areas.

Staff rejected the inclusion of estimated revenues from the unserved areas since they are not "known and measurable." We concur.

F. Operating Revenues Summary

<u>Midvale Total Company Operating Revenues as Filed</u>	\$1,258,613
<u>Commission-approved adjustments</u>	
Local Service Revenues	(\$81,599)
Network Access Service Revenues	(\$103,718)
Interstate USF	\$15,687
Miscellaneous	(\$2,073)
Uncollectables	\$715
<u>Total Company Operating Revenues (per Commission)</u>	\$1,087,625
<u>Midvale Intrastate Operating Revenues (per Commission)</u>	\$730,428

G. Plant Specific Expenses

1 Midvale TY plant specific expenses are \$127,720 for the total Company. Midvale proposed a
2 pro forma adjustment increasing this amount by \$27,462 for estimated expenses for the unserved
3 areas.

4 Staff opposes Midvale's pro forma adjustments since they are not "known and measurable" as
5 they are related to the unserved areas. Staff proposes plant specific total Company expenses of
6 \$127,720 which amounts to a total of \$82,035 after the separation of interstate expenses.

7 Consistent with our exclusion of pro forma adjustments to revenues, we will exclude the
8 corresponding pro forma adjustments to expenses. We concur with Staff's recommended intrastate
9 plant specific expenses of \$82,035.

10 H. Other Plant Expenses

11 Midvale's proposed TY amount is \$62,925 for the total Company. Midvale proposes a pro
12 forma adjustment increasing the amount by \$21,595 to reflect its request to include estimated
13 expenses from the unserved areas.

14 Staff disagrees with Midvale's pro forma adjustment since the expenses from the unserved
15 areas are not "known and measurable." Staff proposed a total Company amount of \$62,925. Staff
16 proposes intrastate Other Plant Expenses of \$33,451 to reflect intrastate expenses.

17 We concur with Staff and adopts Staff's proposed figure of \$33,451 for intrastate Other Plant
18 Expense.

19 I. Depreciation Expense

20 Midvale increased its TY Depreciation Expense of \$186,282 by \$101,161 to reflect its request
21 to include estimated Depreciation Expense from the unserved areas.

22 Staff disallowed Midvale's pro forma adjustment since the expenses are not "known and
23 measurable." Staff also determined that Midvale's current depreciation rates should be adjusted to
24 better reflect plant lives. As a result of Staff's removal of Midvale's pro forma adjustment and the
25 new depreciation rates, Staff proposes a Depreciation Expense of \$236,039. After the removal of
26 interstate Depreciation Expense, Staff recommends intrastate Depreciation Expense of \$140,844.

27 Midvale concurs with Staff's proposed depreciation rates. We adopt Staff's proposed
28 depreciation rates and Staff's proposal to not include expenses related to unserved areas. As such,

1 Midvale's intrastate Depreciation Expense is determined to be \$140,844.

2 J. Customer Operations Expense

3 Midvale proposed TY Customer Operations Expenses of \$96,131 for the total Company.
4 Midvale proposed a pro forma adjustment to account for expenses related to the unserved areas in the
5 amount of \$20,968.

6 Staff rejected Midvale's proposal since these expenses are related to the unserved areas and
7 are not "known and measurable." As such, Staff determined Midvale's Customer Operations
8 Expense to be \$96,131 and \$72,531 for intrastate Customer Operations Expense.

9 We concur with Staff's recommended intrastate Customer Operations Expense figure of
10 \$72,531.

11 K. Corporate Operations Expense

12 Midvale proposes a pro forma adjustment to increase the TY Corporate Operations Expense
13 by \$56,051 for the total Company to reflect its request to include estimated expenses from the
14 unserved areas. Midvale also proposes a pro forma adjustment to increase this amount by \$40,000
15 for the total Company to reflect its estimated rate case expenses for this proceeding. Midvale's
16 proposed total Company Corporate Operations Expense is \$350,931.

17 Staff opposes Midvale's proposal to include \$56,051 in estimated expenses related to
18 unserved areas since they are not "known and measurable." Staff also opposes Midvale's estimate of
19 \$149,000 for rate case expenses. Staff argues that \$41,601 of the rate case expense are engineering
20 costs which are related to the CC&N extension and are not related to the rate case. Staff recommends
21 \$60,000 for rate case expense amortized over three years. Staff is therefore recommending intrastate
22 Corporate Operations Expense of \$186,149.

23 Midvale claims in this case that "the biggest single factor in this expenditure has been the cost
24 of responding to the Staff's discovery requests. All told, the Staff served a total of six rounds of
25 written discovery on the Company, totaling more than 115 questions...." (Williams Rebuttal 5-6). In
26 addition, Qwest and Citizens did intervene and serve discovery requests on Midvale. We find that it
27 is reasonable to amortize \$90,000 in rate case expense over a three-year period, and concur with
28 Staff's exclusion of the \$56,051 for the unserved areas.

1 L. Property Taxes and Other Taxes

2 According to its application, Midvale's TY Property Taxes and Other Taxes are \$81,282 for
3 the total Company. Midvale proposes a pro forma adjustment to increase this amount by \$9,103 for
4 the total Company to include estimated taxes for the unserved areas.

5 Staff opposes Midvale's pro forma adjustment to TY Property Taxes and Other Taxes since it
6 believes that the estimated taxes from the unserved area are not "known and measurable." As a
7 result, Staff is recommending \$81,282 in Property Taxes and Other Taxes for the total Company
8 which amounts to \$51,630 in intrastate Property Taxes and Other Taxes.

9 We concur.

10 M. Miscellaneous (Interest Expense)

11 In its application, Midvale has listed its TY Miscellaneous (Interest Expense) as \$25,107 for
12 the total Company. Midvale is proposing a pro forma adjustment to increase this amount by \$55,023
13 to reflect additional Miscellaneous (Interest Expense) for the unserved areas.

14 Staff disagrees with Midvale's proposal. Staff opposes the inclusion of any interest expense
15 in the calculation of operating income since it is considered a "below the line" item. As such, Staff
16 has eliminated all Miscellaneous (Interest Expenses) from Midvale's proposal and is recommending a
17 zero balance. Staff opposes Midvale's pro forma adjustment to increase Miscellaneous (Interest
18 Expense) for the unserved areas since these expenses are not "known and measurable."

19 Staff's recommendations are reasonable and should be adopted. Interest Expenses are "below
20 the line" and are not included in the calculation of Operating Income. As such, Staff's
21 recommendations shall be adopted.

22 N. Federal and State Income Tax

23 In its application, Midvale did not cite any Federal or State Income Taxes. According to
24 Staff, Midvale's general ledger shows TY intrastate Federal and State Income Tax of negative
25 \$3,040. It is Staff's position that income tax expense should be calculated based on the adjusted
26 jurisdictional revenues and expenses. Staff calculated the TY income tax liability using the Arizona
27 jurisdictional revenues and expenses. Staff is recommending increasing intrastate federal and state
28 income tax by \$43,577. We concur.

1 ...
2 ...
3 O. Statement of Net Operating Income

4	<u>Total Company Operating Revenues</u>	\$1,087,625
5	<u>Operating Expenses (per Application)</u>	\$1,165,690
6	<u>Commission-approved Adjustments</u>	
7	Plant Specific Expenses	(\$27,462)
8	Other Plant Expenses	(\$21,595)
9	Depreciation Expense	(\$51,404)
10	Customer Operations Expense	(\$20,968)
11	Corporate Operations Expense	(\$66,051)
12	Property Taxes and Other Taxes	(\$9,103)
13	Miscellaneous (Interest Expense)	(\$80,130)
14	Federal and State Income Tax	\$43,577
15	<u>Total Operating Expenses</u>	\$932,554
16	<u>Total Company Net Operating Income</u>	\$155,071
17	<u>Net Intrastate Operating Income</u>	\$113,439

18 VI. RATE OF RETURN

19 Witnesses from Staff and Midvale presented cost of capital analyses to be considered as
20 evidence by the Commission in determining a fair value rate of return for purposes of these
21 proceedings.

22 A. Capital Structure

23 Midvale's actual capital structure at December 31, 1999 and the configurations recommended
24 by the parties are as follows:

	<u>12/31/99</u>	<u>Midvale</u>	<u>Staff</u>
25	<u>Short-Term Debt</u>	0.00%	1.8%
26	<u>Long-Term Debt</u>	20.0%	22.2%
27	<u>Common Equity</u>	80.0%	76.0%
28			77.4%

29 The difference between Midvale and Staff's proposed capital structures is due to Midvale's
30 inclusion of \$37,695 in Short-Term Debt in its capital structure. Staff disagreed with Midvale's
31 inclusion of this Short-Term Debt since it has not been included in Midvale's capital structure since
32 1997, indicating that short-term debt does not appear to be a permanent method of financing. We
33 concur.

1 B. Cost of Debt

2 Midvale proposes a weighted cost of short and long-term debt of 5.51 percent. Staff
3 recommends that a cost of long-term debt of 5.47 percent be adopted. This represents the cost rates
4 on Midvale's Rural Telephone Finance Cooperative and Rural Utility Services loans. This is the
5 same cost of debt proposed by Midvale after accounting for Staff's removal of the \$37,695 in short-
6 term debt.

7 During the hearing, Midvale agreed that Staff's removal of the \$37,695 in short-term debt was
8 proper. We concur.

9 C. Cost of Equity

10 Midvale proposed a cost of equity of 13.0 percent. Midvale used three distinct methodologies
11 to determine its cost of equity. Midvale used a Discounted Cash Flow ("DCF") analysis, a risk
12 premium analysis, and a comparable earnings method. Midvale believes that the Commission should
13 focus on the mid-range of its estimates which is 10.9 percent to 12.25 percent for the DCF method,
14 11.0 percent to 12.25 percent for the risk premium analysis, and 12.0 to 14.0 percent for the
15 comparable earnings approach.

16 Midvale's DCF analysis analyzed market data from Regional Bell Operating Companies to
17 arrive at a midpoint of 11.58 percent. Midvale estimated the cost of equity capital for other major
18 telecommunications carriers at 10.9 to 12.25 percent.

19 Midvale also used a risk premium approach which is intended to measure the additional return
20 required by investors for bearing the additional risk. Midvale used market returns and yields on
21 three-month Treasury Bills reported by the Federal Reserve. Midvale's risk premium approach
22 resulted in a midpoint of 11.63 percent.

23 In using the comparable earnings method, Midvale analyzed the returns of a wide range of
24 firms in both the industrial and telecommunications sectors reflecting data for over 900 companies.
25 Midvale then considered the full spectrum of information concerning returns earned in the
26 unregulated sectors and concluded that the average opportunity cost of equity capital to a typical
27 unregulated firm is in the neighborhood of 12.5 to 14.5 percent.

28 Staff proposed an 11.50 percent cost of equity. Staff arrived at this proposal based on its

1 analysis which used comparable earnings, DCF and Capital Asset Pricing Model ("CAPM")
2 methodologies. Staff selected five publicly traded telecommunications companies in its analysis.
3 Staff's comparable earnings method resulted in historic earned returns ranging from 24.3 to 26.7
4 percent which it claims was skewed by U S WEST's reported return on equity of 199.7 and 130.8
5 percent for 1998 and 1999 respectively.

6 Staff's DCF analysis, using combinations of spot and average stock prices and earnings,
7 dividend and sustainable growth, produced results ranging from 4.6 to 16.5 percent. Staff believes
8 that its DCF analysis using earnings growth with the average and spot stock price were both 11.8
9 percent. Staff believes these results to be the most reasonable.

10 Staff also considered the CAPM results which reflected the average holding periods of
11 investors. Staff's CAPM analysis resulted in cost of equity of 12.0 to 12.6 percent. Staff then
12 factored in a beta of 0.60 to reflect a lower risk for Midvale as a company providing regulated
13 telecommunications services.

14 Staff is recommending a cost of equity of 11.50 percent for Midvale. Staff's recommendation
15 is based upon the result of Staff's DCF analysis which produced a cost of equity of 11.80 percent.
16 Staff then adjusted this calculation downward to account for what Staff believes is Midvale's
17 decreased financial risk related to its Arizona capital structure as well as Midvale's risk as compared
18 to the earnings of the companies analyzed in the comparable earnings approach which are from
19 unregulated, competitive operations.

20 While Midvale has risks which may be less than those associated with unregulated,
21 competitive carriers, Midvale has risks inherent to a small rural carrier providing service to less than
22 2,000 total customers, 638 of which are in Arizona. A small rural exchange carrier may face a
23 greater risk from increased telephone competition than does a larger provider. Therefore, we do not
24 agree with Staff's proposal to decrease its DCF analysis. A cost of equity of 11.80 percent is
25 reasonable for a carrier such as Midvale and we want to encourage such carriers to extend service to
26 rural unserved areas.

27

28

D. Cost of Capital

	<u>Percentage of total</u>	<u>Cost</u>	<u>Composite Cost</u>
Total Long Term Debt	22.6	5.47%	1.24%
Total Equity	77.4	11.80%	9.13%
			<u>10.37%</u>

VII. GROSS REVENUE CONVERSION FACTOR

Midvale initially proposed a gross revenue conversion factor of 1.6762 in its application. Staff proposed a gross revenue conversion factor of 1.7652 as a result of changes to federal and state tax rates. Midvale agrees with Staff's proposed gross revenue conversion factor of 1.7652. We therefore adopt a gross revenue conversion factor of 1.7652.

VIII. AUTHORIZED INCREASE

With the adjustments adopted herein, the adjusted TY operating income is \$113,439. Further, the 10.37 percent cost of capital is a reasonable rate of return on FVRB as authorized hereinabove. Applying the 10.37 percent rate of return by the FVRB of \$1,241,841 produces required net operating income of \$129,090. This is \$15,651 more than Midvale's TY adjusted operating income. Multiplying the shortfall by the revenue conversion factor of 1.7652 results in an increase in revenues of \$27,627.

IX. RATE DESIGNA. New Service Territory

In its application, Midvale proposes basic single-line residence and business rates for the new exchanges at \$24.00 for basic residence and \$32.00 for business. Midvale proposes to equalize all of its rates as set forth above. Midvale is basing its rates on the combination of its projected costs from the new service territory as well as its existing costs from serving the Young and Cascabel exchanges.

Staff proposes local exchange rates for the new service territory of \$24.00 for residential customers and \$30.00 for business customers. Staff based its recommendation on the initial cost projections filed by Midvale using a rate of return on rate base of 10.37% and an estimated 278 lines for the unserved areas. Staff is proposing slightly higher charges for the extension areas based on the

1 higher costs of serving this area.

2 Midvale's proposed rates are reasonable and will allow the Company a fair rate of return on
3 its investment. These rates are based on projected costs and, therefore, will need to be revisited in the
4 future. At that time, a determination can be made if Midvale is entitled to receive AUSF funding.
5 While the Commission normally charges existing rates in extension areas, in this case the projected
6 cost of serving the unserved areas exceeds the average cost of providing local service in the other
7 exchanges. We concur with Staff's proposed residential rate of \$24.00 and with Midvale's proposed
8 business rate of \$32.00.

9 B. Young and Cascabel Exchanges

10 As discussed above, Midvale proposes to standardize its rates for all of its Arizona customers.
11 Midvale proposes rates of \$24.00 for residential customers and \$32.00 for business customers. At
12 present, Cascabel's local exchange rates are \$21.00 for both residential and business customers. For
13 the Young exchange, the rates are \$12.40 for residential customers, plus zone charges, and \$32.00 for
14 business customers. In addition, Midvale proposes to reduce its intrastate access charges in both
15 exchanges to \$.06 per minute.

16 Staff believes that the rates for the Millsite and Silver Bell exchanges should be slightly
17 higher to reflect the higher cost of serving those areas. Staff proposed residential rates of \$17.15 for
18 the Young exchange and \$21.00 for the Cascabel exchange. Staff also proposes business rates of
19 \$30.00 for both exchanges. Staff opposes Midvale's proposal to decrease access charges. Staff
20 believes that the higher access charges will help compensate Midvale for the higher cost of serving
21 these two exchanges.

22 If Midvale's proposed rate design is adopted, the residential rates for the Young exchange
23 would increase 94 percent, while the increase for the Cascabel residential rate would increase only 14
24 percent. While it is desirable to standardize Midvale's rates for the entire state of Arizona, moving to
25 such a standardization at this time would create a rate shock to those residential customers in Young.
26 In fact, on March 7, 2001 residents of Young circulated a petition signed by 206 customers opposing
27 Midvale's proposed 94 percent rate increase. The petition states that many of the residents of Young
28 are low income, retired, or on disability. We believe it is appropriate to adopt the lower Staff rate

1 design recommendation. After adjusting for higher allowances for rate case expense and return on
 2 equity than that recommended by Staff, we will adopt residential rates of \$18.65 for the Young
 3 exchange and \$22.650 for the Cascabel exchange (See Exhibit A). We agree with Staff that the
 4 reduction in access charges is not necessary or warranted at this time.

5 C. Custom Calling

6 As part of its application, Midvale seeks to consolidate custom calling with its local exchange
 7 rates. Custom calling includes such features as call waiting, call forwarding, three-way calling, speed
 8 calling and fixed calling. Midvale states that the demand for these services in the Cascabel exchange
 9 is low.

10 Staff is opposed to Midvale's custom calling proposal. Staff states that custom calling is not a
 11 part of basic local exchange service and should have a separate price. Staff also believes that demand
 12 may be low due to the current rates being charged. Currently the rates for all of these services
 13 combined totals about \$15.50. Staff proposes a rate of \$2.00 for custom calling which it believes will
 14 encourage greater usage of the custom calling feature.

15 Based upon the level of revenues and rate design adopted herein, we find that custom calling
 16 should be priced at \$3.50.

17 X. ARIZONA UNIVERSAL SERVICE FUNDING

18 As part of its application, Midvale seeks to become a member of the Arizona Universal
 19 Service Fund ("AUSF") and proposes to begin drawing from the fund. Midvale is seeking to draw
 20 funds from the AUSF to cover the costs involved in serving the currently unserved areas of Millsite
 21 and Silver Bell. Midvale expects that 200 customers will ultimately be served in the Millsite
 22 exchange and approximately 185 customers will be served in the Silver Bell exchange. Midvale
 23 estimates that it will need to invest approximately \$1.45 million to serve these areas and the
 24 Company requests \$221,306 annually from the AUSF for its proposal to serve these areas (Ex.S-4; at
 25 11).

26 Staff recognizes that the Commission has been seeking a solution to the problem of rural
 27 unserved areas. The Commission has asked Arizona telephone companies to serve these rural areas
 28 but Staff concedes that this goal has achieved little success (Transcript pg. 125). Midvale states that

1 “the goal of universal service is to make telephone service as pervasive as possible and to ‘make
2 available, directly or indirectly, the funds necessary to accomplish such a policy.’” (Midvale Brief
3 pg. 11-12 citing Morton I. Hamburg & Stuart N. Broadman, *Communications Law and Practice*
4 §5.01(1) (1998). However, the current Commission rules require that, prior to receiving AUSF
5 funds, a company’s costs should not be estimated⁵ and that a company should already be providing
6 service *prior* to seeking AUSF funds.⁶ In this case, Midvale has submitted estimated costs for plant
7 and equipment to serve the Millsite and Silver Bell exchanges. Midvale has not begun providing
8 service and has no current “embedded costs.”

9 Contrary to Midvale’s claims, the Commission’s AUSF rules require more than hypothetical
10 costs in order to qualify for AUSF. As indicated above, the rules contemplate that the area in
11 question is already being *served* and that the cost of providing service be calculated based on the
12 *embedded* costs of the carrier. As Staff points out, embedded costs are generally recognized as
13 historical or “sunk” costs, as opposed to pro forma or estimated costs that are based on estimated or
14 anticipated data. This interpretation of the Commission’s rules is consistent with the FCC’s
15 requirement (absent the granting of a waiver) that the requesting carrier must have facilities in place
16 for two years prior to receiving FUSF funding. This process enables the FCC to base the release of
17 high cost funding on fully embedded facilities.

18 In addition, the Commission’s rules require that AUSF funding is to be provided “net of any
19 universal service support from federal sources” (A.A.C. Rule 14-2-1202.A.). This rule clearly intends
20 AUSF to supplement FUSF and, implicitly, that federal funding should be pursued as the primary
21 source of high cost support rather than AUSF being provided as a precursor to FUSF funding.

22 Staff’s analysis of the costs to provide service to Millsite and Silver Bell concludes that those
23 areas can be served with little or no support from the AUSF. However, until the plant is in service,
24

25 ⁵ R14-2-1202(A) states “The amount of AUSF support to which a provider of basic local exchange service is eligible for a
26 given AUSF support area shall be based upon the difference between the benchmark rates for basic local exchange
telephone service provided by the carrier, and the appropriate cost to provide basic local exchange telephone service as
determined by the Commission, net of any universal service support from federal sources.”

27 ⁶ R14-2-1202(B) states in relevant part “For a small local exchange carrier, the AUSF support area shall include all
28 exchanges *served* by the local exchange carrier in Arizona. The appropriate cost of providing basic local exchange
telephone service for purposes of determining AUSF support for a small local exchange carrier shall be the *embedded*
cost of the incumbent provider (emphasis added).”

1 the costs will be unknown. Staff recommended that the rates for Millsite and Silver Bell be set based
2 on Midvale's estimated costs, which Staff calculated as \$24.00 for residential customers and \$30.00
3 for business customers. Staff points out that Midvale currently receives \$328,874 per year in FUSF
4 support, which equates to \$43.50 per access line per month averaged over Midvale's existing access
5 lines (Staff Brief at 14). Based on this calculation, Staff conservatively assumed that Midvale would
6 receive approximately half that amount (\$21.50 per month) for new customers in the Millsite and
7 Silver Bell exchanges. Staff concluded that the initial local residential exchange rate should be set at
8 \$24.00 to cover all expenses for providing service to these areas.

9 Midvale also opposes Staff's arguments with respect to the timing of FUSF funding.
10 Although Midvale concedes that it is virtually certain that it will be able to obtain FUSF support
11 (Transcript pg. 84), the Company objects to the inclusion of \$21.50 per line per month of FUSF since
12 it believes it will not be receiving FUSF at the time the plant is put into service. Midvale claims that,
13 because it will not be able to immediately receive FUSF support until approximately the first quarter
14 of the third year of service, the Company needs AUSF support until the FUSF funding is available
15 (Reading Rebuttal pg. 8). Staff also points out that the Commission's rules require that AUSF
16 support be "net of any universal service support from federal sources." A.A.C. R14-2-1202(A).
17 Accordingly, companies should seek FUSF funding *prior* to seeking AUSF funding.

18 Under FCC rules, plant must normally be in place for two years before a company can receive
19 FUSF support (47 C.F.R. Secs. 36.611 and 36.612). However, Staff argues that carriers can apply to
20 the FCC for a waiver of this rule and that such waivers have routinely been granted in the past. In the
21 Matter of Border to Border Communications, Inc. 10 F.C.C.R. 5055 (1995). In South Park
22 Telephone Co., AAD 97-41, DA 97-2730 (rel. December 31, 1997), the FCC cited to Border to
23 Border for the proposition that an immediate waiver is likely to be granted in instances where a
24 carrier is serving a previously unserved area and the area would likely have remained without service
25 if the carrier were unable to provide service to the area. The FCC found that such instances present
26 "compelling reasons to permit immediate high cost loop support" (Id.). Midvale cites In the Matter
27 of Freemont Telecom Co., AAD97-56, DA 98-127 (January 23, 1998) to support its argument that
28 the FCC has previously denied waiver requests from carriers seeking FUSF funding prior to the two-

1 year waiting period. Although the FCC denied Freemont's request for a waiver of FCC Rules 36.611
2 and 36.612, it specifically stated that waivers of those rules had been granted in the past "when a
3 requesting carrier proposes to serve or is serving previously unserved areas" (Id. at 5). Based on
4 these prior decisions, it is clear that the FCC has distinguished waiver requests for unserved areas
5 from those that seek funds for serving high cost areas that were previously receiving service. The
6 FCC more recently granted a waiver request under similar circumstances to a carrier that proposed to
7 serve customers in previously unserved areas. In the Matter of Mescalero Apache Telecom, Inc., CC
8 Docket No. 96-45 (Rel. January 18, 2001). In that case, the FCC stated that "[d]enial of immediate
9 high-cost loop support could have the unintended effect of discouraging Mescalero's planned
10 expansion of service to unserved remote areas, thereby frustrating the Commission's goal of
11 promoting the provision of telecommunications services at reasonable rates" (Id. at 12). Given the
12 fact that it will take Midvale considerable time to build out its plant to serve the new customers, there
13 should be ample time for the Company to submit its request for waiver to the FCC prior to the
14 commencement of service to those customers. Indeed, the Staff has offered to assist Midvale in its
15 waiver request application to the FCC (Transcript pg. 170).

16 The Commission's rules provide that a local exchange carrier may request AUSF support in
17 the context of a rate case or "other method as the Commission may prescribe." R14-2-1203. The
18 current Commission rules indicate that a company must already be providing service to the area in
19 which it is seeking AUSF funding after applying for FUSF funding. In this case, Midvale is not
20 serving any customers in the Millsite and Silver Bell exchanges and can only provide estimated costs.
21 While Midvale will undoubtedly have costs in conjunction with serving Millsite and Silver Bell, it
22 has none at this time.

23 We wish to make clear that we strongly encourage Midvale, as well as other similarly situated
24 carriers, to invest in facilities that will enable the provision of telephone service to remote areas that
25 are not served by any other carrier. Accordingly, we will allow a waiver of our rules and grant
26 Midvale's request for AUSF. Midvale is therefore authorized to draw \$71,651 per year from the
27 AUSF beginning with the commencement of service to Millsite and Silver Bell. In accordance with
28 A.A.C. R14-2-1202(A), the AUSF funding shall be net of FUSF funding received for the Millsite and

1 Silver Bell exchanges, and as such, when Midvale begins to receive FUSF funds for these exchanges,
 2 Midvale's AUSF funding shall be reduced by the appropriate pro rata share. We direct Staff to assist
 3 Midvale in preparing and supporting the Company's FCC waiver request, to the extent Midvale
 4 deems such assistance to be necessary.

5 * * * * *

6 Having considered the entire record herein and being fully advised in the premises, the
 7 Commission finds, concludes, and orders that:

8 FINDINGS OF FACT

9 1. Midvale is an Idaho corporation engaged in the business of providing telephone utility
 10 service to the public in Arizona.

11 2. On July 17, 2000, the Commission received from Midvale an application requesting
 12 authority to increase its rates and charges and for disbursement from the Arizona Universal Service
 13 Fund.

14 3. On August 11, 2000, Staff determined that Midvale's application met the sufficiency
 15 requirements of A.A.C. R14-2-103 and that the Company had been classified as a Class A utility.

16 4. In accordance with A.A.C. R14-2-101, a Procedural Order was issued on February 1,
 17 2001 which set the matter for hearing on May 21, 2001.

18 5. In accordance with the Procedural Order, Midvale published notice of its application
 19 in a newspaper of general circulation in its service areas and mailed, by means of a bill insert, a copy
 20 of the notice to each of its customers.

21 6. For ratemaking purposes, the Company's intrastate OCRB and FVRB for the TY
 22 ended December 31, 1999 was \$1,241,841.

23 7. For ratemaking purposes, the Company's adjusted intrastate TY revenues were
 24 \$730,428, its intrastate TY operating expenses were \$616,989, and its existing rates provided
 25 intrastate TY net operating income of \$113,439

26 8. A fair and reasonable rate of return on the Company's FVRB is 10.37%.

27 9. Operating income of \$129,090 is necessary to yield a 10.37 percent rate of return on
 28 the FVRB.

1 IT IS FURTHER ORDERED that Midvale Telephone Exchange, Inc.'s request for an
2 extension of its Certificate of Convenience and Necessity to serve the Millsite and Silver Bell
3 exchanges shall be granted.

4 IT IS FURTHER ORDERED that the rates and charges contained in said tariffs shall become
5 effective for all service provided on and after October 1, 2001.

6 IT IS FURTHER ORDERED that Midvale Telephone Exchange, Inc. shall notify its
7 customers of the rates and charges authorized hereinabove and the effective date of same by means of
8 an insert in its next regular monthly billing.

9 IT IS FURTHER ORDERED that the AUSF funding shall be net of FUSF funding received
10 for the Millsite and Silver Bell exchanges, and as such, when Midvale Telephone Exchange, Inc.
11 begins to receive FUSF funds for those exchanges, Midvale Telephone Exchange Inc.'s AUSF
12 funding shall be reduced by the appropriate pro rata share.

13 IT IS FURTHER ORDERED that a waiver of the Commission's AUSF rules is hereby
14 granted, and Midvale Telephone Exchange, Inc. is authorized to draw \$71,651 per year from the
15 AUSF beginning with the commencement of service to Millsite and Silver Bell.

16 IT IS FURTHER ORDERED that Midvale Telephone Exchange, Inc. shall notify the Director
17 of the Utilities Division, of the date of commencement of service to Millsite and Silver Bell.

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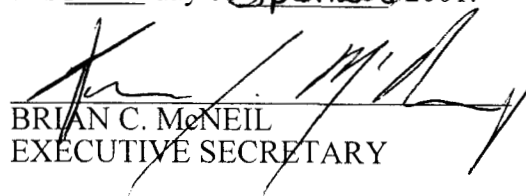
1 IT IS FURTHER ORDERED that a rulemaking docket shall be opened to address, at a
2 minimum, EAS issues such as (1) how "community of interest" should be defined; (2) the
3 significance of call volumes; (3) whether a customer petition should accompany a proposal; (4) how
4 companies can recover the cost of EAS; and (5) how the potential for illegal EAS bridging should be
5 evaluated.

6 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

7 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

8
9 
10 CHAIRMAN  COMMISSIONER  COMMISSIONER
11

12 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
13 Secretary of the Arizona Corporation Commission, have
14 hereunto set my hand and caused the official seal of the
15 Commission to be affixed at the Capitol, in the City of Phoenix,
16 this 5th day of September, 2001.

17 
BRIAN C. McNEIL
EXECUTIVE SECRETARY

18 DISSENT _____
19 SG:dap
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28

1 SERVICE LIST FOR: MIDVALE TELEPHONE EXCHANGE, INC.

2 DOCKET NO.: T-02532A-00-0512

3
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MIDVALE TELEPHONE EXCHANGE
LOCAL RATE AND REVENUE SUMMARY - TOTAL ARIZONA

<u>DESCRIPTION</u>	<u>RATES ADOPTED</u>
<u>Local</u>	
<i><u>Young</u></i>	
Residence - R1	\$ 18.65
Business - B1	30.00
Business - pay	21.00
Foreign Exchange	250.00
Vacation - Zone 1 Charge	10.50
<i><u>Cascabel</u></i>	
Residence - R1	22.65
Business - B1	30.00
Business - pay	21.00
Vacation	10.50
<u>Non-Recurring Charges</u>	
<i><u>Young</u></i>	
Service Order	10.00
Line Connection	25.00
Premise Visit	30.00
<i><u>Cascabel</u></i>	
Service Order	10.00
Line Connection	25.00
Premise Visit	30.00
<u>Other Rates & Charges</u>	
Custom Calling Bundle	3.50
<u>Miscellaneous</u>	
<i><u>Young</u></i>	
Vacation Rate	10.50
Private Line Extension	7.00
<i><u>Cascabel</u></i>	
Vacation Rate	\$ 10.50